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Notes

Borrowing *Foley v. Interactive Data Corp.* to Finance Lender Liability Claims

by

ANN-MARIE DAVIDOW*

Lender liability: "The hot legal theory of the 1980's."¹ Borrowers and their attorneys fear that California is stopping the trend to "protect innocent borrowers from the sometimes arbitrary and capricious actions of their bankers."² By denying borrowers' claims against lenders for tortious breach of the implied covenant of good faith and fair dealing ("covenant"), California courts appear to be "foreclosing on lender liability."³

Some observers perceive the California Supreme Court's decision in *Foley v. Interactive Data Corp.*,⁴ denying tort damages for breach of the covenant in employment termination cases, as fatal to claims for tortious breach in lender liability cases.⁵ This Note, however, argues that *Foley* does not bring to an end the era of redressing borrowers' injuries through tort damages. To the contrary, *Foley* provides the necessary guidelines to determine under what circumstances tort damages are warranted for a lender's bad faith breach of a lending agreement.

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1. Burkhardt, *Court Rulings Reduce Banks' Liability, Make It Harder for Businesses to Challenge Lenders*, San Francisco Examiner, June 25, 1989, at D1, col. 2.

2. *Id.*

3. Checchio, *Foreclosing on Lender Liability*, (San Francisco) Daily Recorder, Nov. 13, 1989, at 1, col. 1 (stating that in the previous 18 months, four appellate court decisions have denied plaintiffs' lender liability tort claims).

4. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

5. See *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 478, 261 Cal. Rptr. 735, 741 (1989) (stating that the *Foley* court's analysis questions the propriety of the tort in lender liability cases); *Mitsui Mfrs. Bank v. Superior Ct.*, 212 Cal. App. 3d 726, 730, 260 Cal. Rptr. 793, 795 (1989) (stating that although the *Foley* court left open the possibility of allowing the tort in lender liability cases, the California Supreme Court would not find a lender's breach tortious in an ordinary arms-length loan transaction); see also Burkhardt, *supra* note 1, at D6, col. 2 (suggesting that *Foley* shows the California Supreme Court may be "reluctant to award punitive damages to injured borrowers").

In its analysis of the employer-employee relationship, the *Foley* court reaffirmed that the contractual relationship between the insurer and insured is not at arms length.⁶ The insured reasonably places great reliance on the insurer not to refuse arbitrarily to pay the insured's claim. The *Foley* court identified the factors justifying the insured's reliance: the economic dilemma suffered by the insured when forced to present a claim, the quasi-public nature of the service provided by the insurer, and the adversity of interests that results from the insurer's economic incentive to breach the insurance agreement and invest the funds.⁷ Tort damages for bad faith breach of the insurance contract both compensate the insured and deter the insurer from breaching.

Similarly, this Note argues that in certain lender liability cases these justifications warrant tort damages for bad faith breach of a loan agreement. A borrower who risks substantially everything to obtain financing may reasonably rely on the lender not to refuse to extend credit arbitrarily. The financial ruin caused by a bad faith breach often cannot be compensated sufficiently by contract damages, which are limited in scope. Furthermore, in certain situations the lender would find it economically beneficial to breach the loan agreement and invest the loan funds elsewhere at a higher rate of return.

Unfortunately, courts have not identified what situations warrant relief beyond contract damages. Nor have courts devised a scheme to equalize the interests of lenders and borrowers so that bad faith breach is not as desirable to the lender and not as devastating to the borrower.

A California court of appeal recently stated that "[a]lthough [borrowers] argue the holding in *Foley* did not eliminate tort liability for the breach of the covenant of good faith and fair dealing in the commercial contract context of this case . . . , the plain fact is such an action never existed."⁸ Perhaps it is true that the action has never existed. Most courts, however, assume that the action exists, but try to determine if the facts warrant tort recovery without first attempting to define the scope of the tort. Regardless of whether such an action currently exists, the question is: *Should* a tort action exist in the lending setting?

While borrowers' and lenders' attorneys debate this issue inside and outside the courtroom, appellate courts will continue to evade answering the question until the California Supreme Court speaks the final word. This Note offers a solution that addresses the concerns of lenders, borrowers, and society as a whole in attempting to align the interests of the parties to the loan agreement.

Part I surveys the nature of tortious breach of the covenant of good faith and fair dealing in general, the *Foley* court's analysis of the tort, and

6. *Foley*, 47 Cal. 3d at 685, 765 P.2d at 390, 254 Cal. Rptr. at 228.

7. *Id.* at 692-93, 765 P.2d at 395-96, 254 Cal. Rptr. at 234.

8. *Mitsui*, 212 Cal. App. 3d at 732, 260 Cal. Rptr. at 797.

the development of the tort in lender liability cases. Part II criticizes lender liability cases for lacking guidelines, argues that *Foley* provides the necessary guidelines, and attempts to show under what circumstances the tort should be allowed in the lending context. Finally, Part III proposes a cap on tort damages in the context of lender liability. Such a solution will maintain economic stability and achieve the goals of tort and contract law.

I. The History of Tortious Breach of the Covenant

Applications of tortious breach of the covenant vary with the types of contractual settings. In each setting, the determinative factor is the relationship between the parties, specifically the characteristics of the relationship distinguishing the transaction from the ordinary arms length commercial transaction for which contract damages are an adequate remedy.

This Part discusses the origin of the tort in the insurance context and its gradual expansion to other commercial contract settings. The discussion then focuses on the California Supreme Court's analysis of the tort in *Foley v. Interactive Data Corp.*,⁹ an employment termination case. Finally, this Part examines the trends regarding tort claims in lender liability cases before and after the *Foley* decision.

A. The Nature of the Tort in General

The covenant is a contract term, inherent in every contract, that imposes on each party to the contract a duty to refrain from doing anything that will deprive the other party of the "benefits" of the contract.¹⁰ The obligation to deal in good faith is codified in the Uniform Commercial Code.¹¹ Section 1-203 of the Uniform Commercial Code (U.C.C.) states that "[e]very contract . . . [to which the U.C.C. applies] imposes an obligation of good faith in its performance or enforcement." U.C.C. section 1-201(19) defines good faith as "honesty in fact in the conduct or transaction concerned."

Like the breach of any other contract term, breach of the covenant gives rise to actions for contract damages. Although it is fundamental that a breach of contract is not a tort,¹² breach of the covenant in certain contractual settings has given rise to an action for tort damages.¹³ In

9. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211, (1988).

10. *Commune v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 658, 328 P.2d 198, 200 (1958) (citing *Brown v. Superior Ct.*, 34 Cal. 2d 559, 564, 212 P.2d 878, 881 (1949)).

11. See U.C.C. § 1-203 (1989) (obligation to perform in good faith); *id.* § 1-201(19) (definition of good faith).

12. W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* 2 (5th ed. 1984).

13. See, e.g., *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984) (tortious breach in commercial context for bad faith denial of

those contexts, the nature of the contractual relationship is such that courts recognize the inadequacy of contract damages to redress the claim of the injured party,¹⁴ as well as the need to deter the party who would benefit financially from breaching the contract.¹⁵

The tort first was recognized in insurance cases when the insurer, in bad faith, refused to pay the claim of its insured.¹⁶ Courts justified allowing tort damages for breach of the insurance contract by finding a "special relationship" between the insurer and the insured.¹⁷ Features of the relationship making it "special" are the quasi-public nature of the insurance industry, the insurer's depiction of itself as a fiduciary, the security seeking motive of the insured as opposed to the commercial motive of the insurer, and ultimately the superior bargaining position of the insurer.¹⁸

Gradually courts expanded the tort as they found "special relationships" in other commercial contract settings.¹⁹ In 1984, the California Supreme Court was faced with the question whether to extend the tort to the commercial context generally.²⁰ In *Seaman's Direct Buying Service v. Standard Oil Co.*,²¹ the court recognized that undoubtedly there are relationships, other than that between insurer and insured, whose similarity to the insurer-insured relationship warrants similar legal treatment—recovery in tort.²² The court avoided naming those relationships, however, and created a slightly different tort: bad faith denial of contract.²³

contract); *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979) (tortious breach in insurance context), *appeal dismissed, cert. denied*, 445 U.S. 912 (1980); *Commercial Cotton Co. v. United Cal. Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985) (tortious breach in banking context); *Wallis v. Superior Ct.*, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984) (tortious breach in employment context).

14. *Wallis*, 160 Cal. App. 3d at 1118, 207 Cal. Rptr. at 128-29.

15. *Egan*, 24 Cal. 3d at 820, 620 P.2d at 146, 157 Cal. Rptr. at 487 (1979).

16. *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 684, 765 P.2d 373, 390, 254 Cal. Rptr. 211, 228 (1988) ("The insurance cases thus were a major departure from traditional principles of contract law.") (citing *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967), as the first time an insured was allowed to recover tort damages for breach of the covenant).

17. *Egan*, 24 Cal. 3d at 820, 620 P.2d at 146, 157 Cal. Rptr. at 487.

18. *Id.* at 819-20, 620 P.2d at 145-46, 169 Cal. Rptr. at 695-96.

19. See *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984) (tortious breach in commercial context for bad faith denial of contract); *Commercial Cotton Co. v. United Cal. Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985) (tortious breach in banking context); *Wallis v. Superior Ct.*, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984) (tortious breach in employment context).

20. See *Seaman's*, 36 Cal. 3d at 758, 686 P.2d at 1160, 206 Cal. Rptr. at 354 (tortious breach found for bad faith denial of a dealership contract between dealer and supplier).

21. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

22. *Id.* at 769, 686 P.2d at 1166, 206 Cal. Rptr. at 362 (footnote omitted).

23. *Id.*, 686 P.2d at 1167, 206 Cal. Rptr. at 363. Bad faith denial of the existence of a contract arguably is a breach of the covenant, however, and *not* a different tort. The action for bad faith denial is premised upon the existence of a contract. Not performing the terms of the

The court described this tortious conduct as "seeking to avoid all liability on a meritorious contract claim by adopting a 'stonewall' position ('see you in court') without probable cause and with no belief in the existence of a defense."²⁴

The *Seaman's* court held that tort damages are proper in this setting because such conduct violates "business ethics."²⁵ Furthermore, the court determined that potential tort liability will not interfere with the "bargaining relationship" or adversely affect the "reasonable expectations" of the parties.²⁶

Acting upon the implications of *Seaman's*, a California court of appeal in *Wallis v. Superior Court*²⁷ enumerated characteristics of the "special relationship" required for tort recovery in cases other than insurance:

(1) the contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a non-profit motivation, i.e., to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party 'whole'; (4) one party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform; and (5) the other party is aware of this vulnerability.²⁸

The *Wallis* court found that under these circumstances, contract damages are inadequate to make the injured party whole. Tort damages are also necessary to discourage this type of bad faith behavior.²⁹ The *Wallis* court determined that these circumstances are not limited to insurance, but exist in other areas such as employment.³⁰

contract is a breach of contract, the nonperformance of which is a breach. A party denying the existence of a contract in bad faith clearly is not performing according to the terms of the contract and therefore has committed a breach in bad faith regardless of whether the denial gives rise to a separate tort. Hence, there is really no difference between the two torts. If any difference exists, it seems negligible and certainly not worthy of a separate label. See Putz & Klippen, *Commercial Bad Faith: Attorney Fees—Not Tort Liability—Is the Remedy for "Stonewalling,"* 21 U.S.F. L. REV. 419, 459 (1987) ("there is no rational way to distinguish denial of the existence of a contract from any other excuse for denying liability"). Perhaps the difference that *Seaman's* recognized can best be explained by its statement that it is tortious to adopt a "stonewall position" when "in addition to breaching the contract, [a party] seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists" (that is, recognizing a difference between bad faith nonperformance and avoiding liability in bad faith). *Seaman's*, 36 Cal. 3d at 769-70, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

24. *Seaman's*, 36 Cal. 3d at 769-70, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

25. *Id.* at 770, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

26. *Id.*

27. 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984).

28. *Id.* at 1118, 207 Cal. Rptr. at 129.

29. *Id.* at 1117-18, 207 Cal. Rptr. at 128.

30. *Id.* at 1118-19, 207 Cal. Rptr. at 129.

Until the recent California Supreme Court decision in *Foley v. Interactive Data Corp.*,³¹ other courts utilized the *Wallis* factors to determine whether a breach of the covenant is tortious. These courts found that the nature of the relationship between the contracting parties was either "special," in which case the injured party could recover tort damages for breach of the covenant, or not "special," in which case the injured party could recover only contract damages.³²

B. The Nature of the Tort According to *Foley*

*Foley v. Interactive Data Corp.*³³ has been described as a dramatic upset to the evolution of the tortious breach of the covenant.³⁴ *Foley's* employment was terminated after he informed his employer that the Federal Bureau of Investigation was investigating *Foley's* supervisor for embezzlement.³⁵ Not only did the California Supreme Court deny *Foley's* claim for tortious breach of the covenant, but the court also declined to recognize tortious breach of the covenant in the employment termination context generally.³⁶ The *Foley* court concluded that the employer-employee relationship is not "sufficiently similar" to the insurer-insured relationship to "warrant judicial extension of the proposed additional tort remedies" when weighed against the "countervailing concerns about economic policy and stability, the traditional separation of tort and contract law, and finally, the numerous protections against improper terminations already afforded employees."³⁷

31. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

32. See, e.g., *Standard Wire & Cable Co. v. Ameritrust Corp.*, 697 F. Supp. 368, 373 (C.D. Cal. 1988) (applying California law, district court granted defendant lender's motion for summary judgment on plaintiff borrower's claims for tortious breach of the covenant because "the *Wallis* 5-part test [was] not . . . satisfied"); *Martin v. U-Haul Co.*, 204 Cal. App. 3d 396, 413-14, 251 Cal. Rptr. 17, 26-27 (1988) ("special relationship" as defined in *Wallis* was not found in dealership contract between rental company and rental dealer); *Okun v. Morton*, 203 Cal. App. 3d 805, 826, 250 Cal. Rptr. 220, 233 (1988) (court agreed with the holding in *Wallis* and adopted its reasoning to find no special relationship between majority partner and minority partner in partnership agreement); *Multiplex Ins. Agency v. California Life Ins. Co.*, 189 Cal. App. 3d 925, 937, 235 Cal. Rptr. 12, 20 (1987) (trial court committed reversible error by failing to instruct jury on characteristics of "special relationship" as defined in *Wallis* in determining tortious breach of contract between insurance agency and insurance company). But see *Welch v. Metro-Goldwyn-Mayer Film Co.*, 207 Cal. App. 3d 164, 192, 254 Cal. Rptr. 645, 660-61 (1988) (declining to apply *Wallis* criteria, found bad faith employment discharge case distinguishable from the *Wallis* breach of "an agreement to provide pension benefits after the employment relationship had ended").

33. 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

34. *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 477, 261 Cal. Rptr. 735, 740 (1989).

35. *Foley*, 47 Cal. 3d at 664, 765 P.2d at 375-76, 254 Cal. Rptr. at 213-14.

36. *Id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234-35.

37. *Id.*

Unlike the cases preceding and following it, in *Foley* the court made no assumptions about expanding the tort outside the insurance area (and specifically to the employment context). Instead, the court performed an in-depth analysis of the propriety of tort recovery in the employment termination context.³⁸ The analysis included a criticism of prior cases for assuming a cause of action existed, a consideration of the varying approaches of scholars, and a comparison between the employer-employee relationship and the insurer-insured relationship.³⁹

The *Foley* court described the recognition of the tort in the insurance context as an exception to the general rule that breach of a contract term gives rise to an action for contract damages but not tort damages.⁴⁰ The court then criticized the employment termination cases for placing employment termination in the exception category without recognizing that tort recovery lacked precedent in the employment area,⁴¹ and without examining insurance and employment relationships to determine whether the justifications for tort recovery in the insurance context pervade the employment context.⁴²

38. Compare *id.* at 682-700, 765 P.2d at 389-401, 254 Cal. Rptr. at 227-39 (18 full pages devoted to tortious breach of the covenant) with *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 767-74, 686 P.2d 1158, 1166-70, 206 Cal. Rptr. 354, 362-66 (1984) (seven full pages devoted to tortious breach of the covenant) and *Wallis v. Superior Ct.*, 160 Cal. App. 3d 1109, 1115-19, 207 Cal. Rptr. 123, 127-30 (1984) (four full pages devoted to tortious breach of the covenant) and *Cleary v. American Airlines*, 111 Cal. App. 3d 443, 453-56, 168 Cal. Rptr. 722, 727-30 (1980) (just under four full pages devoted to tortious breach of the covenant).

39. *Foley*, 47 Cal. 3d at 682-700, 765 P.2d at 389-401, 254 Cal. Rptr. at 227-39.

40. *Id.* at 684, 765 P.2d at 390, 254 Cal. Rptr. at 228.

41. *Id.* at 687, 765 P.2d at 392, 254 Cal. Rptr. at 230. The *Foley* court pointed out: "In only three cases outside of California have courts held that a breach of the covenant of good faith and fair dealing gives rise to tort damages." *Id.* at 686 n.26, 765 P.2d at 391-92 n.26, 254 Cal. Rptr. at 229-30 n.26 (citing *Carter v. Catamore Co.*, 571 F. Supp. 94, 97 (N.D. Ill. 1983) ("summarily and without analysis, stat[ing] that tort damages were available for breach of the covenant in an employment case"); *Dare v. Montana Petroleum Mktg. Co.*, 212 Mont. 274, 687 P.2d 1015, 1020 (1984) (finding tort liability for breach of an employment contract's implied covenant of good faith and fair dealing); *K Mart Corp. v. Ponsock*, 103 Nev. 39, 732 P.2d 1364 (1987) (employment termination case)).

42. *Id.* at 685, 765 P.2d at 390, 254 Cal. Rptr. at 228-29. The problem with the earlier cases, as the *Foley* court regarded it, was "the decisions' uncritical incorporation of the insurance model into the employment context, without careful consideration of the fundamental policies underlying the development of tort and contract law in general or of significant differences between the insurer/insured and employer/employee relationships." *Id.* at 689, 765 P.2d at 393, 254 Cal. Rptr. at 231-32 (footnote omitted). The *Foley* court criticized *Cleary v. American Airlines*, 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980), for unduly relying on insurance law without further examination into the propriety of extending tort liability to the employment context. *Foley*, 47 Cal. 3d at 687, 765 P.2d at 392, 254 Cal. Rptr. at 230. *Foley* then criticized several other employment cases for relying "uncritically" on *Cleary*. *Id.* at 688, 765 P.2d at 392, 254 Cal. Rptr. at 230-31 (criticizing *Huber v. Standard Ins. Co.*, 841 F.2d 980 (9th Cir. 1988); *Koehrer v. Superior Ct.*, 181 Cal. App. 3d 1155, 226 Cal. Rptr. 820 (1986); *Gray v. Superior Ct.*, 181 Cal. App. 3d 813, 226 Cal. Rptr. 570 (1986); *Khanna v. Microdata*

Foley disregarded earlier cases and consulted the scholarly publications to determine when tortious breach should be available outside the insurance context, if at all.⁴³ As courts have been inconsistent in their tortious breach decisions, so also scholars are divided on expanding the tort outside the insurance area.⁴⁴ Some commentators focus on the distinctions between the employer-employee and insurer-insured relationships to argue that tort recovery should be allowed within the limitations that define the relationship as "special."⁴⁵ These commentators endorse the use of a "special relationship" test like that in *Wallis*. They argue that under certain circumstances, public policy warrants recognition of the tort remedy in non-insurance cases. The circumstances to which they refer are those that make the setting similar to insurance:

(1) one of the parties to the contract enjoys a superior bargaining position to the extent that it is able to dictate the terms of the contract; (2) the purpose of the weaker party in entering into the contract is not primarily to profit but rather to secure an essential service or product, financial security or peace of mind; (3) the relationship of the parties is such that the weaker party places its trust and confidence in the larger entity; and (4) there is conduct on the part of the defendant indicating an intent to frustrate the weaker party's enjoyment of the contract rights.⁴⁶

Others argue against a "special relationship" test in the employment context on the basis that employment is not sufficiently analogous even to

Corp., 170 Cal. App. 3d 250, 215 Cal. Rptr. 860 (1985); *Wayte v. Rollins Int'l*, 169 Cal. App. 3d 1, 215 Cal. Rptr. 59 (1985); *Rulon-Miller v. International Business Machs.*, 162 Cal. App. 3d 241, 208 Cal. Rptr. 524 (1984); *Shapiro v. Wells Fargo Realty Advisors*, 152 Cal. App. 3d 467, 199 Cal. Rptr. 613 (1984); *Crosier v. United Parcel Serv.*, 150 Cal. App. 3d 1132, 198 Cal. Rptr. 361 (1983)).

43. *Foley*, 47 Cal. 3d at 690, 765 P.2d at 394, 254 Cal. Rptr. at 232.

44. *See id.* at 690-92, 765 P.2d at 394-95, 254 Cal. Rptr. at 232-33 (discussing three distinct approaches); *see infra* notes 45-50 and accompanying text.

45. *Id.* at 690-91, 765 P.2d at 394, 254 Cal. Rptr. at 232-33 (citing *Louderback & Jurika, Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F. L. REV. 187 (1982)).

46. *Id.* (quoting *Louderback & Jurika, supra* note 45, at 227 (*Louderback and Jurika* argue that although the employer is not technically a fiduciary to the employee, circumstances, such as a case in which the employer is a large corporate entity, arise in which the employee has a right to rely on the employer not to breach the employment contract. *Louderback & Jurika, supra* note 45, at 222-23. The large corporate employer, maintain *Louderback and Jurika*, not only is in a superior bargaining position, but its practices have a potentially adverse affect on a large percentage of the public. *Id.* at 223. Notably, they would allow the tort claim in the case of a contractual relationship between a "builder-lender" and a "new home buyer." *Id.* at 225-26. The builder-lender gains an advantage over the new home buyer because of its real estate experience. The lender's experience enables it to dictate the terms of the contract and the buyer's inexperience leads it to rely on the lender to draft a fair contract and not arbitrarily breach that contract. *Id.*). *Foley* noted that these "special relationship" factors were used by the court in *Wallis* to conclude "that the employment relationship was analogous to that of insurer and insured and justified the availability of tort relief." *Id.* at 691 n.29, 765 P.2d at 395 n.29, 254 Cal. Rptr. at 233 n.29.

recognize the tort, much less to define factors satisfying a claim.⁴⁷ These commentators argue that the differences between employment and insurance are the inequality of bargaining power in insurance versus the equality of bargaining power in employment, the fiduciary status of the insurer versus the non-fiduciary status of the employer, and the quasi-public nature of the service the insurer provides versus the private nature of the service the employer provides.⁴⁸

Still other commentators argue that the special relationship test is illusory because there is no adequate way to define the "special relationship" short of a case-by-case determination, which in turn at least requires allowing the injured to bring a tort claim.⁴⁹ Furthermore, they label the special relationship test a failure because it does not explain the justifications for tort liability.⁵⁰

The *Foley* court agreed with the approach of Miller and Estes,⁵¹ rejecting an extension of the tort even to employment termination cases with similarities to insurance cases.⁵² The court was not convinced that the relationship between employer and employee was "special" enough to warrant allowing an employee to sue for tort damages when the employer terminates in bad faith.⁵³

The court held that fundamental differences between employment and insurance preclude an extension of the tort to employment termination cases because insurance relationship characteristics generally are not found in the employment relationship.⁵⁴ Specifically, the *Foley* court found differences between insurance and employment in three fundamen-

47. *Id.* at 691, 765 P.2d at 395, 254 Cal. Rptr. at 233 (citing Miller & Estes, *Recent Judicial Limitations on the Right to Discharge: A California Trilogy*, 16 U.C. DAVIS L. REV. 65, 90-91 (1982); Note, *Defining Public Policy Torts in At-Will Dismissals*, 34 STAN. L. REV. 153, 165-67 (1981) (authored by Brian F. Berger)).

48. *Id.*, 765 P.2d at 395, 254 Cal. Rptr. at 233 (citing Miller & Estes, *supra* note 47, at 91; and Note, *supra* note 47, at 165-67).

49. *Id.* at 691-92, 765 P.2d at 395, 254 Cal. Rptr. at 233 (quoting Putz & Klippen, *supra* note 22, at 478-80).

50. *Id.* at 692, 765 P.2d at 395, 254 Cal. Rptr. at 233 (quoting Note, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CALIF. L. REV. 1291, 1299 (1985) (authored by Michael H. Cohen). The test failed in four respects:

(1) it does not explain why it "justifies tort liability" for otherwise legal conduct, or for conduct which may give rise to contract remedies, (2) use of the concept "is inadequate to define the scope and application of a tort duty of good faith and fair dealing," (3) use of the model "fails to distinguish between breach of the implied covenant of good faith and fair dealing and "bad faith breach of contract," and (4) the model does not provide justification for imposition of punitive damages and thus "might serve to unfairly chill legitimate conduct."

Id. (quoting Note, *supra*, at 1299-1301) (citation omitted).

51. See Miller & Estes, *supra* note 46 (argument against special relationship test because of the lack of similarities between insurance and employment).

52. *Foley*, 47 Cal. 3d at 692, 765 P.2d at 395, 254 Cal. Rptr. at 234.

53. *Id.*

54. *Id.* at 692-93, 765 P.2d at 395-96, 254 Cal. Rptr. at 234-35.

tal areas: the economic dilemma suffered by the injured upon breach of the contract, the quasi-public-service nature of the field, and the alignment of interests between the parties to the contract.⁵⁵ These differences were sufficient to tip the scale in favor of disallowing the tort.

The court determined that the insured faces great economic difficulties when the insurer breaches the insurance contract by refusing to satisfy a claim. The insured has nowhere to turn; no other insurance company will provide relief funds once the damage has occurred. After having foregone opportunities to contract with other insurance companies, the insured cannot now resort to the marketplace. Thus, the breach leaves the insured with an economic dilemma.⁵⁶ The employee who is fired arbitrarily does not suffer the same economic dilemma. The employee can and must go to the marketplace and make a reasonable attempt to secure other employment.⁵⁷ Although the employee may have difficulty in landing a new job, the difficulty does not arise directly as a result of the employee having foregone other employment opportunities upon employment with the defendant.

The second fundamental difference is the quasi-public-service nature of the insurance industry as opposed to the private nature of the employment industry.⁵⁸ The insurer sells protection from potential economic harm to the individual who is seeking financial security, not profit; the employer is "selling" a job and not financial security. Likewise, the employee is not purchasing a type of financial security distinguishable from that sought by anyone entering a typical commercial contract.⁵⁹

The third fundamental difference is the alignment of the contracting parties' interests in breaching or not breaching the contract.⁶⁰ If the interests are at odds, the party in whose interest it would be to breach must be discouraged from breaching to protect the integrity of the contract.⁶¹ Of course, a disincentive is not necessary when neither party would find it economically appealing to breach the contract. When the insurer's duty to pay the insured is triggered by the occurrence of an event against which insurance was sought, the interests of the insurer and insured are "financially at odds": payment siphons the insurer's funds and replenishes the insured's. Money is transferred from the insurer to the insured

55. *Id.*, 765 P.2d at 395-96, 254 Cal. Rptr. at 234.

56. *Id.* at 692, 765 P.2d at 395-96, 254 Cal. Rptr. at 234.

57. *Id.*, 765 P.2d at 396, 254 Cal. Rptr. at 234 (citing Mauk, *Wrongful Discharge: The Erosion of 100 Years of Employer Privilege*, 21 IDAHO L. REV. 201, 208 (1985)). The requirement that the employee try to find another job arises from her duty to mitigate damages. *Id.* (citing *Parker v. Twentieth Century-Fox Film Corp.*, 3 Cal. 3d 176, 181-82, 474 P.2d 689, 692, 89 Cal. Rptr. 737, 740 (1970)).

58. *Id.* at 692-93, 765 P.2d at 396, 254 Cal. Rptr. at 234.

59. *Id.*

60. *Id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234.

61. *See id.*

only if the particular claim is paid.⁶² In the employment context, however, "[i]f there is a job to be done, the employer must pay someone to do it."⁶³ Therefore, the interests usually are aligned because of the mutual economic benefit of continued employment.⁶⁴

In balancing considerations for and against allowing the tort, the *Foley* court determined that the concerns for "economic policy and stability," the desire to maintain the "traditional separation of tort and contract law," and the "numerous [statutory] protections against improper terminations already afforded employees," add further weight to the disallowance of the tort.⁶⁵

The concern for economic policy and stability is based on the predictability of costs in contractual relationships and the lack of predictability in tort awards.⁶⁶ If contract damages are the only available relief for breach of contract, the contracting parties know the extent of their financial obligation when they enter the agreement because contract damages are limited by foreseeability.⁶⁷ But if tort damages are extended to the contractual setting, then the contracting parties do not know their maximum financial obligation because foreseeability is irrelevant in tort.⁶⁸ The potential for enormous tort damages will discourage parties from contracting. Consequently, the party that is most likely to be held liable for large tort awards will alleviate the added burden by shifting the costs to the consumer and by becoming more selective in choosing the parties with whom it will enter into contracts. Thus, potential tort damages threaten economic stability.⁶⁹

A second countervailing concern, the desire to keep tort and contract law separate, derives from the distinct purposes served by contract and tort remedies:⁷⁰ contract damages compensate, while tort damages work to deter as well as compensate.⁷¹ Contract law is designed to enforce party intentions, but tort law is designed to vindicate social policy.⁷²

62. *Id.*

63. *Id.* If there is not a "job to be done," then the employer may usually discharge the employee in good faith. See Respondent's Brief at 56, *Foley v. Interactive Data*, 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988) (No. LA32418).

64. *Foley*, 47 Cal. 3d at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234.

65. *Id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234-35.

66. *Id.* at 683, 765 P.2d at 389, 254 Cal. Rptr. at 227 (citing Putz & Klippen, *supra* note 23, at 432).

67. CAL. CIV. CODE § 3300 (Deering 1984).

68. CAL. CIV. CODE § 3333 (Deering 1984); 22 AM. JUR. 2D *Damages* § 133 (1988).

69. *Foley*, 47 Cal. 3d at 695-96, 765 P.2d at 398-99, 254 Cal. Rptr. at 236-37.

70. *Id.* at 683, 765 P.2d at 389, 254 Cal. Rptr. at 227.

71. *Id.*

72. *Id.*

The social policy furthered by tort damages is the careful avoidance of harming others.⁷³ Society is neutral, however, toward injury from contract breach.⁷⁴ Efficient breach theorists even argue that society would welcome an economically efficient contract breach because the economic benefit to the breaching party would exceed the loss to the injured party, thus "promot[ing] the efficient allocation of resources and benefit[ing] society as a whole."⁷⁵

A third concern adding strength to arguments for disallowing the tort is the availability of statutory protections against bad faith employment termination.⁷⁶ Labor laws provide relief for discriminatory discharges based on age, sex, race, and religion, as well as the exercise of rights under workers' compensation laws and participation in union activities.⁷⁷

The *Foley* court's discussion, however, was not yet finished. The court recognized that contract damages are inadequate to compensate and deter the potential injury caused by some unwarranted discharges.⁷⁸ The issue to be addressed was "how far courts can or should go in responding to these concerns regarding the sufficiency of compensation by departing from long established principles of contract laws."⁷⁹ The California Supreme Court answered this question by deciding that the prob-

73. Putz & Klippen, *supra* note 23, at 430.

74. *Id.*

75. *Id.* at 430-31 (citing R. POSNER, *ECONOMIC ANALYSIS OF LAW* 93-95, 105-15 (3d ed. 1986)). See also Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 948 (1982). Macneil provides the following example to illustrate the efficient breach theory:

Assume that Athos owns a woodworking factory capable of taking on one more major project. He contracts to supply Porthos with 100,000 chairs at \$10 per chair, which will bring Athos a net profit of \$2 per chair, or \$200,000 on the contract. Before any work takes place, Aramis, who sells tables, approaches Athos. Although there are several chair factories in the area, only Athos's factory can make tables. If Athos will supply Aramis with 50,000 tables, Aramis will pay him \$40 per table. Athos can produce the tables for \$25, so he can make a profit of \$750,000 if he uses his factory for Aramis's tables. But to do so, he must breach his contract with Porthos. There are other chair factories, and Porthos will be able to get the chairs from one of them—for example, from D'Artagnan's. Let us assume that because of his distress situation Porthos will have to pay D'Artagnan 20% more than Athos's price for comparable chairs, and that Porthos will sustain \$100,000 in incidental administrative costs and consequential costs such as damages for delay to his customers. Even with these costs, Porthos will lose only \$300,000 because of Athos's breach, and Athos can reimburse him in full and still make \$450,000 profit, over twice the profit from his contract with Porthos.

Id. (quoting Linzer, *On the Amoralit[y] of Contract Remedies—Efficiency, Equity and the Second Restatement*, 81 COLUM. L. REV. 111, 114-15 (1981)).

76. *Foley*, 47 Cal. 3d at 693 n.30, 765 P.2d at 396 n.30, 254 Cal. Rptr. at 234 n.30.

77. *Id.* Additionally, the employee may bring a tort claim for breach of public policy. *Id.*

78. *Id.*, 765 P.2d at 396-97, 254 Cal. Rptr. at 235.

79. *Id.* at 694, 765 P.2d at 397, 254 Cal. Rptr. at 235.

lem is better left to the legislature, and thus courts should not grant any relief beyond contractual remedies.⁸⁰ The court foresaw economic and judicial chaos if it assumed the role of granting remedies outside the realm of contract law for breach of contract.

C. The Nature of the Tort in Lender Liability Cases

Foley marks a change in the trend of lender liability cases. In pre-*Foley* cases, courts first assumed that tort recovery was available and then proceeded to weigh *Wallis*-type factors⁸¹ to determine if the lender and borrower enjoyed a "special relationship." Courts awarded tort damages only if they found this "special relationship" between the parties.⁸² Lender liability cases after *Foley* have questioned the very existence of the tort.⁸³ These cases, however, have not resolved the issue and have continued to utilize the *Wallis* test.⁸⁴ The attitude toward the tort seems to have changed since the *Foley* decision, but the application of the tort has remained the same. The status quo likely will remain until the California Supreme Court explicitly addresses the issue.

1. The Pre-Foley Cases

Early lender liability cases focused on public policy considerations in determining whether the facts gave rise to tort damages.⁸⁵ Although there was no tortious breach under the particular facts, the court in *Wagner v. Benson*⁸⁶ assumed, without deciding, that a bad faith claim may be based on a borrower-lender relationship.⁸⁷ The tort had not yet been extended beyond insurance, but the *Wagner* court found no reason to

80. *Id.* at 696, 765 P.2d at 398, 254 Cal. Rptr. at 236-37.

81. *See supra* note 32 and accompanying text.

82. *See, e.g.,* Standard Wire & Cable Co. v. Ameritrust Corp., 697 F. Supp. 368 (C.D. Cal. 1988) (purportedly applying California "law" by applying the special relationship test).

83. *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 477-78, 261 Cal. Rptr. 735, 740-41 (1989); *see also* *Mitsui Mfrs. Bank v. Superior Ct.*, 212 Cal. App. 3d 726, 730, 260 Cal. Rptr. 793, 795 (1989) ("*Foley* may leave this question open").

84. *See Price*, 213 Cal. App. 3d at 478, 261 Cal. Rptr. at 741; *Mitsui*, 212 Cal. App. 3d at 733, 260 Cal. Rptr. at 797.

85. *See Wagner v. Benson*, 101 Cal. App. 3d 27, 34, 161 Cal. Rptr. 516, 520 (1980) ("Since tort liability is ultimately imposed to achieve a desirable social climate, 'public policy' plays a major role in determining the standard of conduct required by a particular factual situation.") (citing W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 3, at 15-16 (4th ed. 1971)).

86. 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980).

87. *Id.* at 34, 161 Cal. Rptr. at 520. In *Wagner*, the bank and borrowers (individuals) agreed that if the outstanding loan amount rose above 75% of the periodically calculated value of the collateral (a cattle herd), the bank could require the borrowers to pay the necessary amount to decrease the loan amount to the 75% margin. Cattle prices dropped significantly and the borrowers refused to pay the second of two margin calls. Consequently, the bank forced a sale of the cattle to pay the balance of the loan. *Id.* at 31, 161 Cal. Rptr. at 519. The borrowers unsuccessfully sued for breach of the covenant. *Id.* at 34, 161 Cal. Rptr. at 521.

limit the tort to the insurance context. Instead, the court said that the decision to extend the tort should be made after considering issues of public policy.⁸⁸ *Wagner* thus recognized that in certain situations public policy would dictate imposing tort damages on a lender whose breach of the lending agreement threatened the ideal social environment.⁸⁹

Another early case, *Sawyer v. Bank of America*,⁹⁰ described the tort as "consist[ing] in bad faith action, extraneous to the contract, with the motive intentionally to frustrate the obligee's enjoyment of contract rights."⁹¹ The *Sawyer* court, however, held that under the facts of the case, the plaintiff did not sustain his cause of action for breach of the covenant.⁹²

The plaintiff, a farmer and customer of the defendant bank for several years, purchased a truck and financed the purchase through the defendant. The dealer prepared a security agreement providing that the seller would obtain insurance if the buyer did not. The security agreement then was assigned to the bank. As had been his practice in the past with this bank, the plaintiff did not apply for insurance, but instead relied on the bank to maintain the insurance coverage. This had been the procedure followed for at least four vehicles purchased by the plaintiff and financed by the defendant. Due to a clerical error the bank let the policy expire. A subsequent fire damaged the plaintiff's truck; but because of the expired insurance policy, he was unable to collect any repair money from the insurance company. The bank also refused to pay for the repairs.⁹³

The plaintiff successfully sued for the breach of the bank's contract obligation to obtain and maintain insurance on the truck.⁹⁴ The *Sawyer* court, however, held that the plaintiff could not recover general damages for emotional distress. The court could find no authority to support tort liability based solely on the lender's refusal to admit contract liability.⁹⁵ To sustain the cause of action, therefore, the plaintiff would have to show that the breach itself—failure to maintain insurance—was in bad faith.⁹⁶

88. *Id.* at 33-34, 161 Cal. Rptr. at 521.

89. *See id.* The *Wagner* court held that the bank's practices "d[id] not violate social standards of fair dealing" because the scope of the duty imposed by the covenant extends only to the "benefits of the agreement." *Id.* at 34, 161 Cal. Rptr. at 521. A good investment in cattle was not a "benefit" of the contract; therefore, there was no breach. *Id.*

90. 83 Cal. App. 3d 135, 145 Cal. Rptr. 623 (1978).

91. *Id.* at 139, 145 Cal. Rptr. at 625 (citing *Berkeley Lawn Bowling Club v. City of Berkeley*, 42 Cal. App. 3d 280, 286, 116 Cal. Rptr. 762, 766 (1974); *Brewer v. Simpson*, 53 Cal. 2d 567, 589, 349 P.2d 289, 300, 2 Cal. Rptr. 609, 620 (1960)).

92. *Id.* at 139, 145 Cal. Rptr. at 625-26.

93. *Id.* at 138, 145 Cal. Rptr. at 625.

94. *Id.*

95. *Id.* at 139, 145 Cal. Rptr. at 626.

96. *See id.*, 145 Cal. Rptr. at 625-26. *But cf.* *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 769-70, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 363 (1984) (holding

One of the first lender liability cases actually to compare the bank-customer relationship to an insurance relationship is *Commercial Cotton Co. v. United California Bank*.⁹⁷ Although it involved a depositor rather than a borrower, *Commercial Cotton* has been cited as support for extending the tort to the bank-customer relationship.⁹⁸

In *Commercial Cotton*, the court held the defendant bank liable for tort damages for debiting a commercial checking account on a check containing unauthorized signatures.⁹⁹ The court based its decision on the similarities between banking and insurance. The court found that both were "highly regulated industries performing vital public services substantially affecting the public welfare."¹⁰⁰ As a result, the depositor is "totally dependent on . . . the bank's honesty and expertise."¹⁰¹

The court also recognized the similarities in the motive of the bank and the insurer. Like the insurer, the bank has the "very commercial purpose of making money by using the deposited funds."¹⁰² This motive often conflicts with the security seeking motive of the depositor and the

that "a party to a contract may incur tort remedies when, in addition to breaching the contract, it seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists").

97. 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

98. See, e.g., *Barrett v. Bank of America*, 183 Cal. App. 3d 1362, 1369, 229 Cal. Rptr. 16, 20 (1986) (following the holding in *Commercial Cotton* and finding a fiduciary relationship between the personal guarantors of a loan and the lending bank).

The *Barrett* plaintiffs, personal guarantors of a loan, were principal shareholders in a small corporation. The continuing personal guarantees were secured by trust deeds on two houses, one of which was the plaintiffs' personal residence. Upon notice from the bank that because of losses the corporation was not in the required financial position, the plaintiffs, relying on the financial advice of defendant's officer, agreed to merge their corporation with another. The advising officer allegedly assured the plaintiffs that the merging corporation would be responsible for the loans and that their personal guarantees would be released by the bank. The personal guarantees, however, were not released. The merging corporation filed bankruptcy and foreclosure proceedings were initiated against plaintiffs' personal residence. The plaintiffs sold their home and were forced to give up the proceeds of the sale. *Id.* at 1365-66, 229 Cal. Rptr. at 17-18.

Although the plaintiffs did not bring an action for tortious breach of the covenant, they did prevail on a fraud claim, which is more difficult to sustain. Not only did the court find a special relationship between the bank and the personal guarantors, but it also found facts sufficient to create a fiduciary relationship between the two parties. *Id.* at 1369, 229 Cal. Rptr. at 20-21.

The court based its finding of such a relationship on the plaintiffs' perception that their relationship with the bank officer was "very close," on their reliance on the officer's financial advice, on their disclosure of confidential information with respect to the financial status of the corporation, and on the bank's potential gain from the merger. *Id.* at 1369, 229 Cal. Rptr. at 20-21.

99. *Commercial Cotton*, 163 Cal. App. 3d at 513-14, 209 Cal. Rptr. at 552.

100. *Id.* at 516, 209 Cal. Rptr. at 554.

101. *Id.*

102. *Id.*

insured. The court concluded that the bank and its depositor share at least a "quasi-fiduciary relationship."¹⁰³

Also focusing on the relationship between the parties, a federal district court applying California law in *Standard Wire & Cable Co. v. Ameritrust Corp.*¹⁰⁴ assumed that in California, tortious breach may be alleged under the *Wallis* "special relationship theory."¹⁰⁵ The plaintiff, a closely held corporation, alleged that the defendant credit corporation orally agreed to lend it funds but later rejected the previously accepted security and refused to deliver the funds.¹⁰⁶ The court held that the special relationship test failed because the parties entered into the transaction at arms length, and their sole motive was to increase profitability.¹⁰⁷ Thus, contract damages were sufficient to compensate the plaintiff.¹⁰⁸

A more recent pre-*Foley* case, *Kruse v. Bank of America*,¹⁰⁹ also held that the tort cause of action exists, but that the facts did not support the claim.¹¹⁰ The *Kruse* case arose from a complicated series of related loan transactions.¹¹¹ Cross-complainants, the Jewells, claimed that the bank had wrongfully induced them to borrow large amounts to keep an apple processing company from failing. The cross-complaint alleged "that once the Jewells were hopelessly overextended, the Bank reneged on its promise to provide long-term financing"¹¹² which would have kept the company and the Jewells from declaring bankruptcy. In addition, after the bank obtained the Jewells' assets, the bank "betrayed" the Jewells by not following through with its promise to pay the Jewells' other creditors.¹¹³ The Jewells claimed that their bankruptcy and emotional distress directly resulted from the bank's actions, which were contrary to its repeated assurances that it would extend funds and take care of the Jewells.¹¹⁴

The *Kruse* court held that the facts did not support the Jewells' claim for bad faith denial of contract.¹¹⁵ The court reasoned that the tort claim may only arise when the party not only breaches the contract but also denies in bad faith that an enforceable contract exists.¹¹⁶ There was no enforceable oral or written contract between the bank and the Jewells

103. *Id.*

104. 697 F. Supp. 368 (C.D. Cal. 1988).

105. *Id.* at 373.

106. *Id.* at 371.

107. *Id.* at 373.

108. *Id.*

109. 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988), *cert. denied*, 109 S. Ct. 870 (1989).

110. *Id.* at 60, 248 Cal. Rptr. at 230.

111. *Id.* at 44-51, 248 Cal. Rptr. at 219-24.

112. *Id.* at 52, 248 Cal. Rptr. at 224-25.

113. *Id.* at 52, 248 Cal. Rptr. at 223-24.

114. *Id.* at 49-51, 248 Cal. Rptr. at 224.

115. *Id.* at 60, 248 Cal. Rptr. at 230.

116. *Id.* at 57, 248 Cal. Rptr. at 228.

for the long-term loan; therefore, the court found that the precondition to the tort claim was not satisfied and the facts did not state a claim for bad faith denial of contract.¹¹⁷

The *Kruse* court did not actually say that there can never be a tort claim in this setting. The court seemed to recognize that a tortious breach of the covenant by bad faith denial of contract is actionable in the lender-borrower setting.¹¹⁸

This recognition of the tort coupled with a finding of insufficient evidence to support the tort claim is a theme running throughout the pre-*Foley* lender liability cases. Public policy considerations and special relationships present justifications for allowing tort claims in the pre-*Foley* cases. In none of the cases, however, did the court perform critical analyses of the lending industry and lender-borrower relationships to determine under what circumstances the tort would be warranted.

2. *The Post-Foley Cases*

The pre-*Foley* theme of recognition of the tort but denial of the claim persists in the post-*Foley* cases. Unlike the pre-*Foley* cases, however, two post-*Foley* cases have questioned the *existence* of the tort in the lender-borrower setting.¹¹⁹ Once the question is posed, the post-*Foley* cases retreat and resort to the same standards as applied in the pre-*Foley* cases.

In *Mitsui Manufacturers Bank v. Superior Court*,¹²⁰ the defendants, a borrowing corporation and personal guarantors of short-term notes, cross-complained that the plaintiff bank tortiously breached the covenant by refusing to honor its promise to extend credit on short-term notes until the corporation could obtain long-term financing.¹²¹ The court held that the cross-complainants alleged no facts to differentiate the particular transaction from the "ordinary arms-length commercial transaction" for which "ordinary contract damages" are adequate.¹²²

The *Mitsui* court admitted that *Foley* left open the possibility of extending the tort to the lender-borrower setting. The court, however, predicted that the California Supreme Court would not extend the tort to

117. *Id.* at 58, 248 Cal. Rptr. at 228.

118. *See id.* at 60, 248 Cal. Rptr. at 230.

119. *See Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 478, 261 Cal. Rptr. 735, 741 (1989) (implying that tortious breach of the covenant is not a firmly established legal theory); *Mitsui Mfrs. Bank v. Superior Ct.*, 212 Cal. App. 3d 726, 730, 260 Cal. Rptr. 793, 795 (1989) ("While *Foley* may leave this question open, albeit narrowly," the California Supreme Court "would not permit such an action" in the ordinary lender liability setting.).

120. 212 Cal. App. 3d 726, 260 Cal. Rptr. 793 (1989).

121. *Id.* at 728-29, 260 Cal. Rptr. at 794.

122. *Id.* at 731, 260 Cal. Rptr. at 796.

the "ordinary" situation in which a lender breaks its promise to extend short-term loans.¹²³

Mitsui rejected the notion that a bank may tortiously breach any contract that it enters into.¹²⁴ Instead the court emphasized that the nature of the contract is critical, listing the *Wallis* factors as determinative.¹²⁵ The *Mitsui* court did not define the tort further, but merely discussed why the parties were in equal bargaining positions.¹²⁶

Another recent case, *Price v. Wells Fargo Bank*,¹²⁷ based its holding on *Wallis* and left unanswered the impact of *Foley* on lending. In *Price*, the borrowers sued Wells Fargo Bank for tortious breach of the covenant. On February 28, 1983, Wells Fargo and the borrowers entered into three loan agreements secured by the borrowers' ranch property. The loans were to enable the borrowers to pay off a loan with Crocker Bank. Although the parties had negotiated that the loans would be repaid over five years, the promissory notes stated maturity dates within one year. The bank official allegedly reassured the protesting borrowers that the loans would be "redone" to reflect the five-year plan.¹²⁸

The borrowers made several interest payments on the three loans, but did not pay the balance of the principal on the erroneous maturity date. Nearly one month later the bank notified the borrowers that the loans were past due. Although the borrowers attempted to negotiate restructuring the loans to reflect the parties' initial understandings, Wells Fargo refused and threatened foreclosure.¹²⁹

The parties finally agreed to a revised payment schedule, which the borrowers proved unable to keep. After further unsuccessful negotiations, the borrowers resorted to borrowing from friends and selling various real and personal property to pay off the loan two and one-half years sooner than the original agreement provided.¹³⁰

123. *Id.* at 730, 260 Cal. Rptr. at 795.

124. *Id.* at 731, 260 Cal. Rptr. at 796.

125. *Id.* The "significant factors" include

unequal bargaining strength between the parties, an inadequacy of ordinary contract damages or other remedies, adhesiveness of contract provisions adversely impacting the damaged party which are either neutral toward or benefit the other, public concerns that parties to certain types of contracts conduct themselves in a particular manner, the reasonable expectations of the parties or a fiduciary relationship in which the financial dependence or personal security by the damaged party has been entrusted to the other.

Id.

126. *See id.* at 731-32, 260 Cal. Rptr. at 796-97 (the parties were in equal bargaining positions because there was no "commercial 'uniqueness'" in the arrangement between the bank and the company, because in the past the parties had dealt fairly with each other, and because the borrower could have chosen not to accept the long-term financing from the bank).

127. 213 Cal. App. 3d 465, 261 Cal. Rptr. 735 (1989).

128. *Id.* at 471-72, 261 Cal. Rptr. at 736-37.

129. *Id.* at 472, 261 Cal. Rptr. at 737.

130. *Id.* at 473-74, 261 Cal. Rptr. at 737-38.

The *Price* court affirmed the summary judgment in favor of Wells Fargo.¹³¹ The court concluded that the borrowers' allegations that they were banking customers and beneficiaries of a fiduciary relationship with defendant, together with an explanation of the loan transactions, were not sufficient to state a tort claim.¹³² The court stated that the plaintiffs did not argue that these allegations passed "the rigorous five-part test of the *Wallis* decision."¹³³ Furthermore, the court found that tort liability could not be found under *Seaman's Direct Buying Serv. v. Standard Oil Co.*¹³⁴ because there was no separate pleading of bad faith denial of contract. According to *Price*, this tort is distinct from the tortious breach of the covenant.¹³⁵

The court, in dicta, criticized both *Commercial Cotton*, which found a quasi-fiduciary relationship between bank and depositor,¹³⁶ and *Barrett*, which found a quasi-fiduciary relationship between bank and loan customer,¹³⁷ as "inconsistent with both past authority and current trends in the law."¹³⁸

The *Price* court also suggested that although *Foley's* impact cannot be determined with complete certainty, *Foley* might stunt the growth of tort claims in the lender liability setting:

[U]ntil the Supreme Court says otherwise, it may still be argued that a noninsurance contract was "tortiously breached if it contained characteristics similar to those which allow a finding of tortious breach in an insurance contract." . . . But the implications of [*Foley's*] analysis pre-
sage a close scrutiny of tort recovery for breach of the implied covenant of good faith and fair dealing outside of the insurance context.¹³⁹

131. *Id.* at 487, 261 Cal. Rptr. at 747.

132. *Id.* at 478, 261 Cal. Rptr. at 741.

133. *Id.*

134. *See Seaman's Direct Buying Serv. v. Standard Oil Co.*, 36 Cal. 3d 752, 769, 686 P.2d 1158, 1167, 206 Cal. Rptr. 354, 363 (1984) (finding tortious the bad faith denial of the existence of a contract).

135. *Price*, 213 Cal. App. 3d at 478, 261 Cal. Rptr. at 741 (citing *Kruse v. Bank of America*, 202 Cal. App. 3d 38, 57-60, 248 Cal. Rptr. 217, 228-30 (1988), *cert. denied*, 109 S. Ct. 870 (1989)). *But see supra* note 23 (arguing that there is no real difference between the *Seaman's* tort and tortious breach of the covenant; therefore, there is no need to plead separate causes of action).

136. *See supra* notes 97-103 and accompanying text.

137. *See supra* note 98.

138. *Price*, 213 Cal. App. 3d at 476, 261 Cal. Rptr. at 740 (footnote omitted). The court found that previous cases characterized both the relationships of bank and depositor, and bank and loan customer as debtor-creditor, which, "under ordinary circumstances," is not a fiduciary relationship. *Id.* at 476-77, 261 Cal. Rptr. at 740 (quoting *Lawrence v. Bank of America*, 163 Cal. App. 3d 431, 437, 209 Cal. Rptr. 541, 545 (1985); citing *Morse v. Crocker Nat'l Bank*, 142 Cal. App. 3d 228, 232, 190 Cal. Rptr. 839, 842 (1983); *Downey v. Humphreys*, 102 Cal. App. 2d 323, 332, 227 P.2d 484, 490 (1951)). The court then described *Foley* and *Mitsui* as moving away from expansion of the tort. *Id.* at 477-78, 261 Cal. Rptr. at 740-41.

139. *Id.* at 478, 261 Cal. Rptr. at 741 (citing *Mitsui Mfrs. Bank v. Superior Ct.*, 212 Cal. App. 3d 726, 260 Cal. Rptr. 793 (1989)). The court, in dicta, stated that *Foley* impliedly

In summary, a post-*Foley* trend is developing as a variation on the previous theme that recognized the tort but denied the claim. Courts addressing the issue have realized that *Foley* plays a significant role in defining the application of the tort to lender liability cases, but have not explained *Foley*'s role. Instead they have returned to the pre-*Foley* theme of applying the *Wallis* factors and denying the claims for insufficient evidence.

II. *Foley* as Justification for Allowing the Tort in Lender Liability Cases

The persistent theme of recognizing the tort in lender liability cases but denying the tort claims is disturbing. Why allow the tort if it is never proven under the facts? This Part argues that the denial of tort claims results from the failure of courts faced with lender liability cases to examine critically the characteristics that distinguish a loan agreement from the ordinary commercial arms length transaction.

The *Foley* opinion includes an in-depth analysis of tortious breach of the covenant. This Part attempts to use the *Foley* court's reasoning to frame a general rule applicable in commercial contexts other than employment termination, particularly commercial lending. The rule, a balancing test, then is applied to the lender-borrower relationship. This Part concludes that there are certain situations in which tort damages are necessary to provide adequate relief to injured borrowers and discourage lenders from arbitrarily breaching the loan agreement. Unlimited tort damages, however, arguably pose as significant a threat to economic stability as preclusion of tort damages. This Part, therefore, lays the groundwork for a proposal to maintain economic stability while addressing the concerns of both lenders and borrowers.

A. The Need for a Well-Defined Rule

The lender liability cases do not address the tort in the lending context satisfactorily. Although the covenant is described as a basis for holding the lender liable, the cases do not elaborate on the requisite behavior to uphold the covenant.¹⁴⁰ In most lender liability cases, courts assume that the *Wallis* factors can be found in the lender-borrower relationship but hold that the facts of the case do not support the tort claim in that situation. These unsupported tort claims raise the question whether there ever can be a lender-borrower relationship that is not an ordinary arms-length transaction, or whether there is a need for the tort

overruled *Commercial Cotton*'s finding that tortious breach is founded on a quasi-fiduciary relationship between the contracting parties. *Id.*

140. Harrell, *The Bank-Customer Relationship: Evolution of a Modern Form?*, 11 OKLA. CITY U.L. REV. 641, 674 (1986).

in the lending context. Purposefully or not, courts have evaded this question through their blind acceptance of the *Wallis* special relationship test.

Now that the California Supreme Court has determined in *Foley* that insurance is an "exception to the rule," courts should scrutinize any extension of the tort beyond insurance.¹⁴¹ The *Wallis* contractual relationship involved employment; therefore, its holding may be questionable under *Foley* because the *Foley* court was not generally convinced that a special relationship exists between the employer and the employee.¹⁴²

Moreover the inquiry called for in *Wallis* may not be appropriate for determining whether the tort exists in *any* situation after *Foley*. The *Wallis* test begins by assuming the tort may exist in a given relationship and then considers whether the tort exists in the particular fact situation.¹⁴³ *Foley* seems to prohibit assuming the tort exists in any relationship other than the insurer-insured relationship. After *Foley*, therefore, the initial inquiry is whether the tort can exist in a particular relationship, not whether the tort is found given certain facts.

The *Wallis* test was not designed for and may not be suited to this new purpose. The *Foley* court mentioned *Wallis* almost indifferently in a footnote to its statement that the proponents of a special relationship test assume that the tort should be recognized in the context of employment relationships.¹⁴⁴ Thus the *Foley* court did not place great weight upon the *Wallis* special relationship test in determining whether and under what circumstances the tort should be extended beyond insurance.¹⁴⁵ And not surprisingly, most lender liability cases have found that the borrower did not satisfy the five-part *Wallis* test.¹⁴⁶

A continued lack of judicial standards will injure both the lender and the borrower. Without definite boundaries, a sympathetic jury could expand the tort beyond its intended scope, which would discourage lenders from contracting with "high-risk borrowers."¹⁴⁷ Ambiguous stan-

141. See *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 689, 765 P.2d 373, 393, 254 Cal. Rptr. 211, 231-32 (1988) (criticizing prior employment cases for not carefully analyzing whether the tort should be extended to the employment termination context).

142. See *id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234-35 (the employer-employee relationship is not sufficiently similar to the insurer-insured relationship to warrant an extension of the tort). See also *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 478, 261 Cal. Rptr. 735, 741 (1989) (predicting that given the opportunity, the California Supreme Court would overrule *Wallis*, but nonetheless applying the *Wallis* test).

143. *Wallis*, 160 Cal. App. 3d at 1118.

144. *Foley*, 47 Cal. 3d at 691 n.29, 765 P.2d at 395 n.29, 254 Cal. Rptr. at 233 n.29.

145. See *id.* at 682-700, 765 P.2d at 389-401, 254 Cal. Rptr. at 227-39 (using 18 full pages without following *Wallis* in analyzing the tort).

146. *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 478, 261 Cal. Rptr. 735, 741 (1989). See also *Mitsui Mfrs. Bank v. Superior Ct.*, 212 Cal. App. 3d 726, 733, 260 Cal. Rptr. 793, 797 (1989) (the "critical" *Wallis* factors were not met).

147. Note, *Bad Faith Lenders*, 60 U. COLO. L. REV. 417, 441 (1989).

dards also could be injurious to the borrower. Without "straightforward instructions concerning trust, confidence, bargaining power and the like," juries may deny tort relief to the borrower arbitrarily.¹⁴⁸ A well-defined rule, however, may achieve proper adjudication of lender liability cases and may serve as a warning mechanism to lenders with respect to what behavior society expects in lending transactions.

B. *Foley v. Interactive Data Corp.*: The Framework for a Well-Defined Rule

Foley provides the California Supreme Court's most recent in-depth analysis of the covenant. Unlike *Wallis* and other prior cases, which based their findings on assumptions that the special relationship exists in any contractual relationship, the *Foley* court made no such assumptions. *Foley* made extensive comparisons between employment relationships and insurance relationships, concluding that there is generally no special relationship between the employer and employee that gives rise to an action in tort for breach of the covenant.¹⁴⁹ The question is, can the *Foley* court's reasoning be used to determine if and to what extent the tort should be allowed in lender liability cases?

The *Foley* court implied that its decision would have a tremendous impact on the business community as a whole.¹⁵⁰ The supreme court realized that other courts would use its analysis in other commercial contexts. Nevertheless, *Foley* added the qualification that its judgment was limited to the employment termination context.¹⁵¹ This realization of the decision's potential coupled with a qualification on the scope of the judgment suggests that the *Foley* court contemplated that its analysis could lead to different results in other factual settings.

Lender liability and banking cases after *Foley* have submitted that *Foley* affects the tort's availability in other types of relationships.¹⁵²

148. See Dorsaneo, *Other Contractual Relationships*, 3 BAD FAITH L. UPDATE 106 (1988) (arguing against categorizing relationships because it could "arbitrarily exclude" some situations in which there was a special relationship, and instead arguing in favor of submitting the question whether there is a special relationship between the contracting parties to the trier of fact).

149. See *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 682-700, 765 P.2d 373, 389-401, 254 Cal. Rptr. 211, 227-39 (1988) (criticizing employment cases, distinguishing between tort and contract law, consulting commentaries' views on the special relationship test, comparing employment and insurance, and discussing countervailing concerns that add strength to disallowing the tort in employment termination cases).

150. See *id.* at 694, 765 P.2d at 397, 254 Cal. Rptr. at 235 ("[s]ignificant policy judgments affecting social policies and commercial relationships are implicated in the resolution of this question").

151. *Id.* at 700, 765 P.2d at 401, 254 Cal. Rptr. at 239-40.

152. See *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 478, 261 Cal. Rptr. 735, 741 (1989) (stating that *Foley's* impact "cannot be assessed with certainty" and following *Wallis* since *Foley* (i.e. the California Supreme Court) did not expressly overrule it); *Mitsui Mfrs. Bank v. Superior Ct.*, 212 Cal. App. 3d 726, 730, 260 Cal. Rptr. 793, 795 (1989) (while *Foley*

category of transactions and places it in the category of transactions that deserve protection from a bad faith breach through tort liability.¹⁵⁷

C. Applying *Foley's* Balancing Test to Lender Liability

Comparing the lender-borrower relationship to the insurer-insured and employer-employee relationships shows that the argument for allowing the tort in the lending liability cases is stronger than in the *Foley* employment termination case. A point-by-point comparison of the economic dilemma, nature of service, and adversity of interests in these relationships is illuminating.

When the insurer refuses to pay the insured's claim, the insured suffers great economic hardship. When the employer fires the employee, however, the employee can turn to the market.¹⁵⁸ The employee also may seek aid from the state, further easing reentry into the job market.¹⁵⁹

No hypothetical situations need be posed to illustrate that borrowers are faced with great barriers in attempting to return to the market. When the lender breaches the lending agreement, like the insured the borrower has nowhere to turn. The borrower also cannot resort to a comparable state insurance system as an employee can. The facts of the lender liability cases are exemplary: most borrowers must resort to bankruptcy.¹⁶⁰ Even if the borrower avoids bankruptcy, the borrower's credit rating will have been destroyed. And even if the credit rating is intact, the borrower will have no collateral to secure a new loan since substantially all the borrower's assets will have been liquidated.¹⁶¹

157. *Id.*

158. *Id.* at 692, 765 P.2d at 396, 254 Cal. Rptr. at 234.

159. The respondent in *Foley* noted that the employee may resort to the California Unemployment Insurance system, which provides "considerable temporary relief to those who have lost their employment for any reason except misconduct." Respondent's Brief at 55, *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988) (No. LA32418).

160. See, e.g., *Standard Wire & Cable Co. v. Ameritrust Corp.*, 697 F. Supp. 368, 371 (C.D. Cal. 1988) (bankruptcy); *Price v. Wells Fargo Bank*, 213 Cal. App. 3d 465, 474, 261 Cal. Rptr. 735, 738 (1989) (borrowers forced to sell bee hives, trucks, cattle, and land for distressed prices); *Mitsui Mfrs. Bank v. Superior Ct.*, 212 Cal. App. 3d 726, 728-29, 260 Cal. Rptr. 793, 794 (1989) (enforcement of continuing guarantees and foreclosure of security interest); *Kruse v. Bank of America*, 202 Cal. App. 3d 38, 49-51, 248 Cal. Rptr. 217, 223-24 (1988) (foreclosure on properties, bankruptcy of individuals and company), *cert. denied*, 109 S. Ct. 870 (1989); *Barrett v. Bank of America*, 183 Cal. App. 3d 1362, 1365-66, 229 Cal. Rptr. 16, 18 (1986) (foreclosure proceedings initiated; plaintiffs sold home to prevent total loss; bank demanded proceeds of sale); *Wagner v. Benson*, 101 Cal. App. 3d 27, 31, 161 Cal. Rptr. 516, 519 (1980) (foreclosure on the cattle that plaintiffs had purchased in their investment in a cattle raising program).

161. See *Hunt v. United Bank & Trust Co.*, 210 Cal. 108, 117, 291 P. 184, 188 (1930) ("Because of [the bank's] unjustified act in refusing to advance the money which defendant [bank] had obligated itself to do, plaintiffs were in no position to acquire the necessary funds, for they were at the end of their financial resources.").

These post-*Foley* cases, however, have left the precise impact for the California Supreme Court to decide.

When the California Supreme Court is faced with a tort claim involving a lending transaction, the court's analysis should parallel that in *Foley*. In *Foley*, the court determined that the tort should not be extended to employment termination cases because the employer-employee relationship does not have the special characteristics that the insurer-insured relationship has.¹⁵³ Likewise, the court should examine whether the lender-borrower relationship is sufficiently similar to the insurer-insured relationship to justify tort damages for breach of the covenant.

The question then arises whether the results under the *Foley* analysis will be the same in the lender liability case as in an employment termination case: will the tort claim similarly fail? Applying the *Foley* court's reasoning to the lender-borrower setting actually should yield a result contrary to the holding in *Foley*.

The *Foley* analysis is a balancing test. On one side of the scale is allowance of the tort in the particular setting. This side is strengthened by the similarity of the particular relationship to the insurer-insured relationship. As the similarity between the relationships increases, the strength of the argument for allowing the tort increases. The similarity of the relationships is determined by comparing the relationship to the insurer-insured relationship in three areas: the economic difficulties suffered as a result of the breach, the nature of the service provided by the breaching party, and the alignment or adversity of the interests of the parties.¹⁵⁴

On the other side of the scale is the disallowance of the tort. This side is strengthened by a preference for maintaining the traditional separation of tort and contract, the policy concern for maintaining a stable economic environment, and the adequacy of the statutory protections already afforded the injured party.¹⁵⁵

The relationship will be sufficiently similar to outweigh these opposing concerns if the factors of economic dilemma, nature of the service, and adversity of interests show that the injured party reasonably has placed special reliance on the breaching party's good faith.¹⁵⁶ This reliance removes the contract from the ordinary commercial arms-length

did not foreclose the availability of the tortious breach in the lender-borrower setting, the California Supreme Court most likely would not allow tortious breach in the ordinary lender-borrower case because it did not in the employer-employee setting); *cf.* *Lee v. Bank of America*, 218 Cal. App. 3d 914, 922-28, 267 Cal. Rptr. 387 (1990) (Johnson, J., concurring and dissenting) (comparing the bank-customer relationship to the insurer-insured relationship under the guidelines of *Foley*, and reasoning that the tort exists in the context of banking).

153. *Foley*, 47 Cal. 3d at 692-93, 765 P.2d at 395-96, 254 Cal. Rptr. at 234-35.

154. *Id.*

155. *Id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 234-35.

156. *Id.* at 692-93, 765 P.2d at 395-96, 254 Cal. Rptr. at 234-35.

Should the borrower somehow obtain a loan, the borrower probably will not be able to retrieve the assets or business interests that were lost as a result of the bad faith breach of the lender. As with the insured, then, the borrower's inability to resort successfully to other sources is a direct result of the borrower having foregone opportunities to secure loan funds from another lender at the outset.

The economic dilemma faced by the borrower seems to be most severe in the case of an individual or small business borrower who has pledged everything to finance a project.¹⁶² Because there is so much more at stake for this type of borrower than for the bank,¹⁶³ the borrower reasonably relies on the bank not to breach its lending agreement. Under these circumstances, the relationship does not stem from an arms length transaction. The economic dilemma faced by an injured individual or small business borrower in a lender-borrower relationship therefore is similar to that of an injured insured party in an insurer-insured relationship.

The next comparison to make is the nature of the service provided by the under relative to that provided by the insurer. The *Foley* court distinguished the insurer-insured relationship from the employer-employee relationship by observing that while insurance has a quasi-public service nature, employment provides no similar public service.¹⁶⁴ The *Foley* court noted that a party contracts with the insurance company to be financially protected when potentially devastating events arise.¹⁶⁵ The court rejected the argument that the employee is seeking financial security by obtaining employment; instead, *Foley* regarded the employment contract as an arms-length bargain between a "dealer" and "supplier."¹⁶⁶

The *Foley* court's simple dealer-supplier analogy cannot be applied to the lender-borrower relationship. It has long been recognized that "banking has ceased to be, if it ever was, a matter of private concern only, like the business of a merchant"; instead banking is a service in the public interest.¹⁶⁷ The quasi-public service status of the bank derives from its domination of individual business interests as well as the economic stability of society as a whole.¹⁶⁸

162. See *supra* note 160.

163. *Id.* (borrowers were individuals or closely held corporations, and lenders were large banks—Bank of America, Wells Fargo bank, Mitsui Manufacturers Bank, Security Pacific National Bank, Lloyd's Bank, and Ameritrust Corporations).

164. *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 692, 765 P.2d 373, 396, 254 Cal. Rptr. 211, 234 (1988).

165. *Id.*

166. *Id.*

167. *State Sav. & Commercial Bank v. Anderson*, 165 Cal. 437, 442, 1332 P. 755, 757 (1913) (quoting *Shaake v. Dolley*, 85 Kan. 598, 604, 118 P. 80, 83 (1911)), *aff'd*, 238 U.S. 611 (1914).

168. See *Kruger v. Wells Fargo Bank*, 11 Cal. 3d 352, 364-65, 521 P.2d 441, 448, 113 Cal. Rptr. 449, 456 (1974) (banks "exert great influence upon the economic health of the nation")

Because of banks' "superior stature" in the community, they manifest an "aura of expertise and reliability that is greater than that of the ordinary commercial enterprise."¹⁶⁹ Oklahoma, in recognizing a policy of evenhandedness, prohibits banks from using their advantages against their customers and requires that banks promote the economic needs of the public.¹⁷⁰

It has been suggested that only certain circumstances give rise to a breach by the bank of its special duty to prevent injury to its customers and the public.¹⁷¹ These circumstances may be grouped into two general categories: when the lender has superior bargaining power, and when the lender diverges from an established course of conduct. The first category is characterized by contractual relationships in which the borrower actually has relied on the expertise, knowledge, or guidance of the lender; and contractual relationships in which the lender retains excessive control over the borrower. The second category includes activities such as sudden demand of payment of a note after repeatedly ignoring late payments, sudden withdrawal of credit without prior notice, or unexpected foreclosure on collateral.¹⁷²

(citing *Franklin Nat'l Bank v. New York*, 347 U.S. 373, 374-75 (1954); A. MICHIE, 1 BANKS & BANKING 2-3 (1973)); *Anderson*, 165 Cal. at 442, 132 P.2d at 757 ("Banks are indispensable agencies through which the industry, trade and commerce of all civilized countries and communities are now carried on. The banker is the universal broker over whose counter the exchanges of supply and demand are, in the final analysis, effected.") (quoting *Shaaake*, 85 Kan. at 604, 118 P. at 83); *Commercial Cotton v. United Cal. Bank*, 163 Cal. App. 3d 511, 516, 209 Cal. Rptr. 551, 554 (1985) (banking "substantially affect[s] the public welfare"); *Frankini v. Bank of America*, 31 Cal. App. 2d 666, 678, 88 P.2d 790, 796 (1939) (banking "intimately" affects public welfare) (citing *People v. Bank of San Luis Obispo*, 154 Cal. 194, 97 P. 306 (1908)); *Harrell*, *supra* note 140, at 643 (banks' "financial power within the community amounts to a virtual financial monopoly in the field of money lending") (quoting *Djowharzadeh v. City Nat'l Bank & Trust Co.*, 646 P.2d 616, 619 (Okla. Ct. App. 1982)).

169. *Harrell*, *supra* note 140, at 681. *Harrell* equated bankers with "doctors and lawyers" because they "enjoy prestige in the community and a deference to their judgment in the area of their specialty (finance, in the case of banks) which induces ordinary persons to rely on that judgment." *Id.*

170. *Djowharzadeh*, 646 P.2d at 619. The *Djowharzadeh* court found that a special relationship existed between the bank and borrower, and that there was sufficient evidence to support a claim for tortious breach of the covenant. *Id.* at 619-20. The court took

particular notice of banking practices and tradition which cultivates, encourages and even advertises the fact that banks can and should be trusted. Indeed, the words "trust," "security" and "guaranty" are a part of the name of many banks, including defendant Bank. The fact that no prior Oklahoma cases or statutes specifically define such a relationship is more of a tribute to past faithful performance of bankers than a proof that a special duty does not exist or need only be optionally observed.

Id. at 620. See also *Harrell*, *supra* note 140, at 669 ("[t]he public [] repose[s] confidence and reliance that such institutions will behave according to the highest ethical standards").

171. *Harrell*, *supra* note 140, at 669, 677, 679.

172. *Id.*

Under certain circumstances, then, the relationship between the lender and the borrower is not at arms length. The unsophisticated borrower relies on the financial expertise of the bank because of the bank's status in the community. In these circumstances, a sudden withdrawal of credit, refusal to extend credit against common practice, or demand of payment has no adverse consequences for the bank and merely allows the bank to take advantage of its supremacy in the lending market to the detriment of the borrower. Thus, the bargaining powers of the unsophisticated borrower and the bank are not equal.

These situations exemplify the need to deter a breach that is in the lender's financial self-interest when the lender has superior bargaining power. The *Foley* court found that the interests of the insurer and insured are adverse when the insured has filed a claim. If the insurer were liable only for contract damages, namely the amount due under the policy plus interest accrued, it would be in the insurer's interest to refrain from paying the insured, invest the money in the market where it has the potential to earn greater returns, and try to force a settlement. In this way, the insurer possibly could pay even less than what it owed under the policy.¹⁷³ By contrast, the insured needs to be paid for the loss that has occurred. The interests of the insurer and the insured thus are financially at odds.

The *Foley* court distinguished the employment termination scenario in which the parties' interests generally are aligned. Assuming that the employer still has need for the employee's job, a fair assumption because otherwise the employee would not be able to prove that the discharge was in bad faith, the employer will have to hire and pay for the services of another employee. By the time a suit is filed and litigated, the employer will have paid someone to perform the services in question. Additionally, the employer will have paid the recruiting and training costs to replace the discharged employee. Therefore, unlike the insurer who will not pay, the employer who wrongly fires an employee is not able to retain money, earn interest, and eventually force a cheap settlement. "To the contrary, he will already have paid fully for the one set of services needed as an input in his productive process—before the plaintiff's contract damages are even calculated."¹⁷⁴

An examination of the respective interests of the lender and borrower shows that under most circumstances they are adverse toward one another. Because the interest of the borrower is always against breach, the economic interest of the lender will be determinable.

173. Brief for Respondent at 56, *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654 (1988) (No. LA32148) (citing *Wallis v. Superior Ct.*, 160 Cal. App. 3d 1109, 1117, 207 Cal. Rptr. 123, 128 (1984)).

174. *Id.*

If the lender is subject only to contract damages upon breach, then from a purely profit-seeking perspective looking only at the particular funds in question, it is in the lender's financial interest not to deliver the loan funds or not to extend credit and demand full payment of the loan. Generally, the measure of contract damages for breach of an agreement to loan money is the difference, if any, between the rate of interest during the term of the loan and the replacement loan's rate of interest (or the interest rate "generally available" when the breach occurred if the borrower is unable to obtain alternate financing).¹⁷⁵ In many cases only nominal damages are recoverable.¹⁷⁶ Special damages, such as lost profits, are recoverable only if they are foreseeable.¹⁷⁷

Before the suit even comes to trial, the lender can retain the loan funds or foreclose on the security interest and invest the funds at a potentially higher return than the nominal contract damages for which it will be liable. The lender also can hope to settle the case for less than it can earn by investing the retained funds.¹⁷⁸

In summary, the cost of the breach ultimately determines the alignment of interests. An employer saves money by performing a contract. By contrast, an insurer saves money by breaching a contract. Similarly, a lender may save money by breaching a contract.

In *Kruse*, the court held that when the bank had promised to repay borrowers' creditors and instead made efforts to liquidate properties held as security, the bank was acting in its "economic self-interest," adverse to the interests of the borrower.¹⁷⁹ The court held that this was not a bad faith breach, however, because it did not find the bank had made an enforceable promise.¹⁸⁰ Perhaps the court would have decided otherwise if it had found a promise by the bank. With financial interests at odds, the bank had nothing to lose and the borrower, everything.

In situations when the bargaining powers of the parties are not equal, namely when the borrower is unsophisticated or is an individual or small business, the borrower reasonably relies on the lender not to breach its promise even if it is in the lender's economic self-interest to do so. Such a transaction is not at arms length, and under these circumstances, the relationship is similar to that of the insurer and insured. A disincentive to breach is necessary. The insurance cases provide potential tort

175. 22 AM. JUR. 2D *Damages* § 93 (1988).

176. *Id.* § 94.

177. *Id.* *Contracts* § 99. The annotation provides a "checklist of elements of proof" needed to establish damages for lost profits, including the "lender's knowledge of [the] borrower's intended use of [the] proceeds," and the "lender's knowledge of [the] unavailability or limited availability of alternative financing on equivalent terms." *Id.* § 100.

178. See Checchio, *supra* note 3, at 2 (banks settle out-of-court in many cases).

179. *Kruse v. Bank of America*, 202 Cal. App. 3d 38, 67, 248 Cal. Rptr. 217, 234-35 (1988), *cert. denied*, 109 S. Ct. 870 (1989).

180. *Id.* at 58-59, 248 Cal. Rptr. at 228-29.

liability as a disincentive for bad faith breach. Likewise, lender liability cases should employ potential tort liability as a disincentive to bad faith breach by the lender.

The propriety of the tort, however, depends on the strength of the similarity between insurance and lending as weighed against the three opposing concerns: the traditional separation between tort and contract, economic stability, and the statutory protection already afforded the borrower against a bad faith breach.¹⁸¹ *Foley* held that employment was not similar enough to insurance to tip the scale in favor of the tort when the similarities were balanced against these opposing concerns.¹⁸² A balancing of the similarities between lending and insurance against the opposing concerns, however, tips the scale in favor of allowing the tort in lending situations.

The *Foley* court explained that the traditional separation between tort and contract is rooted in their different purposes.¹⁸³ The goal of contract law is the protection of party expectations, and the purpose of contract remedies is to compensate.¹⁸⁴ The goal of tort law, however, is to provide disincentives to certain behavior that society will not tolerate; therefore, the purpose of tort remedies is to deter as well as compensate.¹⁸⁵ Because the covenant is a contract term, its breach usually gives rise to only contract damages.¹⁸⁶ *Foley* held that only in rare circumstances, such as those of insurance, will a breach warrant tort recovery.¹⁸⁷ Contract damages will be inadequate because in those circumstances breach of the covenant constitutes behavior that society will not tolerate. The opposing concern of keeping tort and contract separate therefore is weakened under circumstances when the breach imposes injury that society will not tolerate.

The relationship between lender and borrower is most similar to that of insurer and insured when the lender bank breaches its promise to loan funds or extend credit to the individual or small business borrower. The question is, will society tolerate the detriment that this type of borrower suffers, such as loss of property, loss of business, emotional distress, and bankruptcy?

Although the lender's breach may allow the lender to invest the funds at a higher return, thus increasing the flow of funds in the economy, for each breach a business may be destroyed or an individual may be forced into bankruptcy. That party is completely removed from the

181. See *supra* notes 156-57 and accompanying text.

182. *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 693, 765 P.2d 373, 396, 254 Cal. Rptr. 211, 234-35 (1988).

183. *Id.* at 683, 765 P.2d at 389, 254 Cal. Rptr. at 227.

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.* at 684, 765 P.2d at 390, 254 Cal. Rptr. at 228.

market. Society should not tolerate the disabling of these market participants because the economy depends upon the flow of funds produced by their activity. Thus, there is a need to deter the lender from a bad faith breach that will result in the disabling of market participants.

Furthermore, nominal contract damages are inadequate to compensate the borrower who faces a severe economic dilemma involving bankruptcy and loss of substantially all assets. Tort damages are necessary to make the borrower whole under the circumstances in which the lender-borrower relationship is most closely analogous to the insurer-insured relationship.

In *Foley*, the court recognized that contract damages may be inadequate to redress the claims of employees fired in bad faith.¹⁸⁸ The court, however, held that there was an adequate alternative in the wide range of statutory protections afforded the employee.¹⁸⁹

Although banking is a regulated industry, the borrower does not have available statutory protections against a bad faith breach of the loan agreement.¹⁹⁰ Therefore, existing statutes add no strength to the argument for disallowance of the tort.

A third concern is the tort's potential threat to economic policy and stability. Tort awards often are unpredictable because unlike in contract, foreseeability is irrelevant in determining the damages.¹⁹¹ The argument against the tort is that the unpredictable damage awards will lead the lender to raise its rates in an attempt to shift these costs to its customers, or to refuse to lend to certain higher-risk borrowers. Borrowing will become difficult and even impossible for many, and the economy will suffer by the decrease in the flow of funds.¹⁹²

Assuming the argument that tort recovery would threaten economic stability is realistic, the problem is that either way economic stability is threatened. If only contract damages are allowed then the disabling of market participants will threaten economic stability. If tort damages are allowed, the increase in the cost of lending will be directly proportional

188. *Id.* at 693-94, 765 P.2d at 396-97, 254 Cal. Rptr. at 235.

189. *Id.* at 693, 765 P.2d at 396, 254 Cal. Rptr. at 235.

190. See Flick & Replansky, *Liability of Banks to their Borrowers: Pitfalls and Protections*, 103 BANKING L.J. 220, 223-25 (1986) (listing the U.C.C.—requiring good faith—and RICO—for claims for improperly charging excessive interest—as statutory theories of lender liability); Harrell, *supra* note 140, at 641 ("Although [the relationship between bank and its customer] has come to be supplemented by federal and state legislation and regulation, in large part, these laws and regulations have left undisturbed the fundamental nature of the contractual relationship between a bank and its customer") (footnotes omitted); see also Hawley, *Introduction to Lender Liability*, 48 ALA. LAW. 214, 214-15 (1987) (discussing three statutory liability theories—RICO, federal securities liabilities, and the superfund laws—that do not protect a borrower from bad faith breach of the loan contract).

191. 22 AM. JUR. 2D *Damages* § 133 (1988).

192. See Note, *supra* note 147, at 441.

to the increased number of lender liability suits for tortious breach. The increased cost in lending will threaten economic stability.

III. A Legislative Proposal to Achieve an Economic Balance

An economic balance is needed. A cap on the amount of recoverable non-contract damages would provide predictability in tort damages. Limited tort damages dissolve the threats to economic stability, enable the injured borrower's claim to be redressed adequately, and still deter the lender from breaching the contract in bad faith. The ideal cap would equalize the bargaining power and align the economic interests of the parties to a loan agreement.

A cap on non-economic damages has been utilized in medical malpractice cases. In 1975, the California legislature enacted Civil Code section 3333.2, which provides in relevant part:

- (a) In any action for injury against a health care provider based on professional negligence, the injured plaintiff shall be entitled to recover noneconomic losses to compensate for pain, suffering, inconvenience, physical impairment, disfigurement and other nonpecuniary damage.
- (b) In no action shall the amount of damages for noneconomic losses exceed two hundred fifty thousand dollars (\$250,000).¹⁹³

The enactment of this cap on medical malpractice damages was a response to "the medical malpractice insurance crisis,"¹⁹⁴ which the California Supreme Court has declared a legitimate public interest.¹⁹⁵ The high cost of medical malpractice insurance brought on by enormous malpractice judgments, prompted the legislature to place a cap on medical malpractice damages. The potential high cost of lending likewise should

193. CAL. CIV. CODE § 3333.2 (West Supp. 1990).

194. Note, *The Constitutionality of Recent Efforts to Limit Personal Injury Damages Following the 1984-85 MICRA Decisions*, 13 W. ST. U.L. REV. 595, 600 (1986) (authored by Monica Lynch) (stating that the crisis was "quite similar to the current liability insurance crisis"). The legislature summarized its purpose in enacting the statute as follows:

The Legislature finds and declares that there is a major health care crisis in the State of California attributable to skyrocketing malpractice premium costs and resulting in a potential breakdown of the health delivery system, severe hardships for the medically indigent, a denial of access for the economically marginal, and depletion of physicians such as to substantially worsen the quality of health care available to citizens of this state. The Legislature, acting within the scope of its police powers, finds the statutory remedy herein provided is intended to provide an adequate and reasonable remedy within the limits of what the foregoing public health and safety considerations permit now and into the foreseeable future.

Amendment to Assembly Bill No. 1, Ch. 2, Sec. 12.5, § 1(b), 2d Extraordinary Sess., reprinted in 1975 CAL. STATUTES & AMENDMENTS TO THE CODES 4007.

195. American Bank & Trust Co. v. Community Hosp., 36 Cal. 3d 359, 370-74, 683 P.2d 670, 676-78, 204 Cal. Rptr. 671, 677-81 (1984); *Fein v. Permanente Medical Group*, 38 Cal. 3d 137, 162-63, 695 P.2d 665, 683, 211 Cal. Rptr. 368, 386 (1985), *appeal dismissed*, 474 U.S. 892 (1985).

prompt the legislature to enact a cap for tort recovery in lender liability cases.

This legislative proposal is consistent with the *Foley* holding that the legislature should determine non-contract remedies.¹⁹⁶ The court then would be responsible to determine whether the lender and borrower under the facts of the case enjoyed a special relationship sufficiently similar to the relationship of the insurer and insured. Factors indicating that the borrower was unsophisticated, or was an individual or small business relying on the financial expertise of the bank, would be determinative.

Conclusion

The goal of lender liability adjudications is to redress adequately the claims of the borrower while maintaining economic stability. Allowing a limited tort for breach of the covenant is a possible and practical solution. The tort finds its justification in the similarities between lender-borrower relationships and insurer-insured relationships. These similarities outweigh the concerns for limiting breach of the covenant to contract damages.

History of the tortious breach of the covenant shows that the tort is not well-defined in lender liability cases. Because the borrower potentially may suffer severe economic and emotional distress damages, contract damages are inadequate to compensate the borrower when the lender breaches the loan agreement in bad faith. Because of these adverse consequences and the superior status of banks in the community, society should not tolerate this type of behavior by the lender, but rather should hold the lender to a policy of fair dealing and even-handedness. Thus there is a need to allow recovery beyond ordinary contract damages.

Without a limit, however, the sharp increase in the cost of lending due to potential tort liability could threaten economic stability. Therefore, a cap similar to that for medical malpractice claims is desirable to maintain predictability for each party's financial obligation in a loan agreement. The goal of this cap would be to equalize as much as possible the amount at risk for each party to the agreement. This equalization would insure that neither party would find it economically beneficial to breach the contract arbitrarily. Equalization of risk would insure that unless unforeseeable circumstances arose making performance impracticable, it would be more expensive to breach than to fulfill the terms of the contract.

Allowing capped tort damages is a solution that will compensate the borrower, deter the lender, and achieve economic stability. The duty of

196. *Foley v. Interactive Data Corp.*, 47 Cal. 3d 654, 700, 765 P.2d 373, 401, 254 Cal. Rptr. 211, 239 (1988).

good faith and fair dealing will protect each party's interest in obtaining the benefits expected from the contract, and will further society's interest in maintaining the flow of funds in the market.

